INTRODUCTION

The loan portfolio is the largest and most important group of assets in a savings association's balance sheet, therefore the association's financial health is directly proportional to that of its loan portfolio. There are two major risks inherent in lending operations: (1) credit risk, or the risk that a borrower will fail to repay the interest and principal payments of the loan as agreed, and (2) insufficient net earnings (after providing for loan losses), i.e., net earnings will not be sufficient to cover the institution's interest costs and operating expenses.

Low-quality loan portfolios, with excessive loan losses and nonearning assets, was one of the primary reasons for capital deterioration and, ultimately, the failure of savings associations in the 1980s. In order to remain healthy and profitable, a savings association must progressively manage its lending risks by establishing sound lending policies and ensuring that they are carried out by experienced and competent lending staff.

This Section of the Handbook examines the elements of a sound lending policy and outlines some of the major causes of loan problems. It is intended to assist the regulator in pulling together results of examination programs performed in specific lending departments. With these results, the regulator can evaluate the quality of the entire loan portfolio and the effectiveness of loan portfolio management.

Lending Policy

A written lending policy provides the foundation for building a sound loan portfolio. Lending policies must be specific for each institution, however, and management should consider the expertise of its lending personnel, the needs of the institution, and the needs and nature of its community when developing the institution's lending policies.

On December 31, 1992, OTS issued 12 CFR 563.100-101, Real Estate Lending Standards. Identical rules were issued by each of the other federal banking agencies. The rule requires savings associations to adopt written real estate lending policies and procedures and provides guidelines on the scope and overall content of such policies. The Real Estate Lending Standards Rule is discussed more thoroughly in Thrift Activities Handbook Section 212, Real Estate Mortgage Lending.

OTS does not have a specific regulation that requires savings associations to have written lending policies for loans not secured by real estate (or otherwise covered by 563.100-101); however, savings associations are expected to adopt written, well-defined policies that govern their non-real estate lending activities.

A savings association's policy should promote the following objectives:

- To approve and service loans on a safe and sound basis;
- To uphold the board of directors' fiduciary responsibility to invest the institution's funds profitably for shareholders or members while protecting depositors; and
- To serve the legitimate credit needs of the community.

A lending policy should also:

- Clearly state to management the board of directors' objectives in the composition and risk of the loan portfolio.
- Apply to loan purchases and loan participations as well as to loans originated by the institution.
- State the types of reports required by the directorate to monitor the institution's activities.
- Address the servicing, collection, and charge-off of loans.

- Be reviewed periodically by the board of directors to ensure that policy remains appropriate as market conditions change.

The regulator may find that some loans do not comply with an institution's written policies and procedures. The regulator must determine if exceptions to policies are specifically approved as exceptions or if they are a continuing practice that pose a threat to the institution. Policy exceptions may be appropriate in certain instances; however, the reasons for the exceptions should be well documented in the loan file and approved by the board of directors, its delegates, or a committee thereof. Frequent exceptions to a policy may mean that the policy needs revision or may indicate the more serious problem of management's unwillingness or inability to follow policy.

The elements of a sound loan policy are outlined below.

Market Area: The institution's geographic market area should be clearly defined and consistent with the institution's business plan and Community Reinvestment Act (CRA) Statement objectives. The majority of lending activity should occur within this defined market area. When loans are made outside the area, they should be carefully documented, with comments as to the benefits and risks of exceeding the boundary of the lending territory.

Loan Types: The lending policy should state the desired composition of the loan portfolio by loan type. The targeted levels should be based on the expertise of lending personnel, the liability structure of the institution, profitability and competition factors, portfolio diversification policy, and the anticipated credit needs of the community. Specific departmental lending policies should outline borrower qualifications and documentation standards for each type of loan offered.

Maximum Maturities: Loans should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For each type of loan, the lending policy should state the maximum number of months over which loans may be amortized or the maximum length of time to maturity. Specific procedures should be developed for unique situations such as balloon payments and modification of the original terms of a loan.

Loan Pricing: The rates charged for loans should reflect the institution's cost of funds, overhead, credit risk premium, and a reasonable profit, yet must be priced at a level that is competitive in the market.

*Financial An*alysis: Extension of credit on a safe and sound basis requires complete and accurate financial information on the borrower. Complete credit information is not only required at the time the loan is originated, but also must be updated periodically to determine the borrower's continuing ability to service the debt. The lending policy should define the financial statement requirements for audited, nonaudited, fiscal, interim, operating, cash flow, and other statements for businesses and individuals at various borrowing levels. The requirements should be written to indicate clearly that any credit data exception will constitute a violation of the institution's lending policy. In the case of loans secured by real estate, the credit file should contain evidence that the loan was not granted solely on the basis of the appraised value of the security property. An appraisal is only one of many tools necessary to underwrite a loan adequately. Documentation of adequate income to service the proposed debt and proper loan approval(s) should be included in the loan file.

"No-Doc" and "Low-Doc" Loans: Loans granted without evidence of the borrower's financial ability to service the debt are often referred to as "no-doc" loans. No-doc loans violate § 563.170(c)(1). The term "low-doc" refers to loans granted by a lender who obtains less financial information and credit history documentation than it obtains for borrowers who have a less substantial equity position in the mortgaged collateral. Low-doc loans should be granted only pursuant to prudent policies approved by the board of directors and clear procedures that are fully understood by loan underwriting staff. A lender must always analyze and document a borrower's current financial condition and capability to repay the loan on a timely basis.

Because of their higher level of delinquencies and defaults, low-documentation loans should receive a higher level of scrutiny than other loans. Some of the data gathered suggest that underwriting these loans may not have been prudent, with evidence of material overstatement of borrowers' income and understatement of debts.

Regulators should be aware of the secondary market limitations associated with low-documentation loans. Both the Federal National Mortgage Association (FNMA) and the Federal Home Mortgage Loan Corporation (FHLMC) limit the purchase of loans that have less than industry-standard documentation. The purchase of such loans has been limited to a negotiated basis, and usually with credit enhancements required.

A high volume of low-doc loans in proportion to total lending should be considered a warning signal of unsafe and unsound lending, which suggests the need to analyze the payment record of seasoned low-doc loans in the portfolio. Another indicator of possible problems would be the presence in the portfolio of low-doc loans rejected by the secondary market.

Limitation on Aggregate Loans Outstanding: As a guide in limiting the total amount of loans outstanding, relationships to other balance sheet accounts should be established primarily to ensure an adequate level of liquidity. In setting such limitations-which are usually expressed relative to deposits, capital, or total assets-various factors such as credit demand, the volatility of the deposit structure, and the credit risks involved must be considered.

Limits and Guidelines for Purchasing Loans: If sufficient loan demand exists, lending within the institution's market or trade area is safe, promotes customer relationships, fosters the well-being of the area, and develops additional business. The lending policy should limit the number of loans purchased from any one outside source and also state an aggregate limit for such loans. The lending policy should also require that purchased loans meet the same underwriting standards applied to direct loans originated by the institution.

Limits and Guidelines for Concentrations of Credit: Concentrations of credit depend heavily on a key factor (such as a common industry or employer), and when weakness develops in that key factor, every individual loan in the concentration may be affected. Certain types of concentrations may be unavoidable (or even desirable, such as single-family mortgage loans in the association's primary lending area). The directorate should evaluate the risks associated with concentrations and identify those that should be limited or avoided. The lending policy should require that all concentrations be monitored and reported to the board of directors on a periodic basis. Portfolio diversification policies and strategies should be written and implemented when the need is shown by the monitoring reports.

Loan-to-Value Ratios: The lending policy should outline the maximum amount in relation to the collateral value that the institution will advance on a given type of collateral.

Loan Authority: The lending policy should establish limits for each lending officer, based on the officer's experience and tenure with the institution. Lending limits, however, should also be set for group authority. A group of officers should be allowed to approve larger loans than individual members can. Reporting procedures and the frequency of meetings for loans requiring group approval should be defined.

Collection and Charge-Offs: Effective collection policies and procedures can reduce lending risk and prevent many loan losses. The lending policy should define delinquent credit obligations and should dictate the appropriate reports to be submitted to the board. The reports should be sufficiently detailed to enable an assessment of the risk, loss potential, and alternative courses of action. The policy should require a followup collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board for charge-off when they reach a stated period of delinquency.

Credit Underwriting

Section 39(a) of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires the federal bank regulatory agencies to prescribe standards relating to credit underwriting. In a proposed regulation published on November 18, 1993, the agencies established the general parameters of safe and sound credit underwriting practices. The standards, if adopted, would require each institution to establish and maintain prudent credit underwriting practices that:

- are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
- consider the nature of the markets in which loans will be made;
- consider, prior to credit commitment, the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
- establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;
- take adequate account of concentration of credit risk; and
- are appropriate to the size of the institution and the nature and scope of its activities.

Loan Documentation Standards

Section 39(a) of FDICIA also requires the federal bank regulatory agencies to prescribe standards relating to loan documentation. The proposed regulation requires institutions to maintain sufficient loan documentation to:

- enable the institution to make an informed lending decision and to assess risk as necessary on an ongoing basis;
- identify the purpose of the loan and the source of repayment and assess the ability of the borrower to repay the indebtedness;
- ensure that any claim against a borrower is legally enforceable;
- demonstrate appropriate administration and monitoring of a loan; and
- take account of the size and complexity of a loan.

The proposed regulation provides a standard against which compliance can be measured, while at the same time allowing for differing approaches to loan documentation.

On March 30, 1993, the agencies issued a joint policy statement regarding documentation of small- and medium-sized business and farm loans. Under that policy statement, well-managed, well- or adequately-capitalized institutions are allowed to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. Regulators should review the policy statement if the association being examined has used this authority.

In an effort to make the loan documentation requirements for banks and thrifts consistent, the OTS amended loan documentation regulation 12 CFR 563.170(c)(1)-(7) to conform to the interagency policy statement. In addition, as part of the final rulemaking action on Section 39 of FDICIA, OTS may significantly revise the current regulatory loan documentation requirements.

Loan Problems

When reviewing an institution's lending functions, the regulator should be aware that many institutions have had serious problems because directors failed to establish sound lending policies and procedures or failed to monitor conformity of lending practices with lending policies. Major sources and causes of "problem" credits are:

Self-Dealing: Excessive lending to affiliated persons and instances of conflicts of interest necessitate significant supervisory action. For this reason, to prevent conflicts of interest, the lending policy should include guidelines for loans to affiliated persons. Self-dealing occurs in many forms, but usually as an over-extension of credit on an unsound basis to directors, officers, employees, or large shareholders or their interests.

Anxiety for Income: When an institution's management is under pressure to invest excess funds or increase earnings, it may be tempted to invest in high-risk activities not specified in the business plan or lending policy. The earnings potential, however, should not be permitted to outweigh the principle of soundness whereby credits carry undue risks or unsatisfactory repayment terms.

Incomplete Credit Information: Many problem loans can be avoided by verifying credit information provided by borrowers and performing a thorough credit analysis before approving the credit. Complete credit information is the only acceptable and reasonably accurate method for determining a borrower's financial capacity. Comprehensive financial statements, including operating results and other relevant information, should be obtained. The loan file should contain documentation specifying the loan's purpose and a well-defined primary source of repayment. The loan file should also contain evidence that all documentation was analyzed by qualified institution personnel and not used only as "file filler." All information used in the underwriting of a credit should be documented in the loan file.

Failure to Obtain or Enforce Repayment Agreements: The vast majority of borrowers fully intend to repay their loans on inception. Nonetheless, failure to establish proper and realistic repayment provisions or failure to enforce repayment agreements are common causes of loan problems. Repeated renewals and extensions to borrowers may indicate that lending personnel did not adequately underwrite the original loan.

Complacency: The following characteristics manifest complacency and should be guarded against:

- Lack of adequate supervision of old and familiar borrowers;
- Dependence on oral information furnished by borrowers rather than reliable, written financial data; and
- Optimistic view toward known credit weaknesses based on past survival of recurrent hazards and distress.

Lack of Supervision: Many loans that were sound at inception developed into problems and losses because of lack of supervision of the borrower's financial affairs over the loan's lifetime.

Technical Incompetence: Lending personnel must have the technical ability to analyze and evaluate financial statements and other credit information that pertain to the type of credit being granted. When a full understanding of the nature of the credit and the risk involved is lacking, unwarranted losses are certain to develop.

Poor Selection of Risks: Following is a list of some general loan types that fall within the category of poor risk selection:

- Loans to purchase or develop properties, or to finance the establishment of businesses, where the institution advances an excessive proportion of the required capital relative to the equity investment of the owners;
- Loans based solely on the expectation of successfully completing a business transaction;
- Loans for speculative purchases of securities or goods;
- Loans carried without adequate collateral margins of security; and
- Loans made because of other benefits, such as community influence or large deposit balances.

Over-Lending: This is a weakness that may be found when otherwise competent lending personnel fail to adhere to prudent underwriting standards. Loans beyond the reasonable capacity of the borrower to repay are unsound. It is as jeopardizing to lend too much money to a fundamentally sound financial risk as it is to lend to an unsound risk. It is, therefore, important to determine a sound borrower's safe, maximum loan level.

The general limitation for loans to one borrower is 15% of a thrift's capital and surplus; the limit for loans fully secured by readily marketable collateral, i.e., actively traded securities, is an additional 10% of capital and surplus. These limitations are the maximum legally permissible; safe and sound operation may dictate that the thrift follow a lower, more prudent limit. The restrictions on loans to one borrower are discussed further in Thrift Activities Section 211, Loan Portfolio Diversification.

Competition: When an institution is under pressure to increase or maintain market share in a highly competitive market, it may compromise sound credit principles. Temporary gains in growth, however, will ultimately be outweighed by the cost of unsound loans.

INTERNAL LOAN REVIEW

The Competitive Equality Banking Act of 1987 resulted in regulations that require each insured institution to classify its own assets on a regular basis.

While the regulations apply to all assets held by an insured institution, this section addresses only the evaluation of systems implemented by institutions to monitor lending portfolio risk. Accordingly, the examination procedures are designed to enable regulators to evaluate the quality and effectiveness of the internal loan review function. If it is determined that problem loans are being identified in a timely manner and that the institution's internal loan classification ratings prove to be reasonably accurate, it may not be necessary to perform an analysis of the remaining portfolio provided the internal review is current and there have been no material changes since the last review.

It is important the regulator recognize that while an internal loan review system may take many forms, e.g., reliance on loan officers to identify problem loans, review of junior officers' loans by a senior lending officer, use of a qualified, part-time person, or an independent department staffed with credit analysts, effective systems have the following common objectives:

- To help minimize loss by the early identification of credit weaknesses;
- To provide essential information for determining the adequacy of valuation allowances;
- To monitor compliance with policies, procedures, laws, and regulations;
- To provide senior management and the board of directors with an objective assessment of the overall quality of the loan portfolio; and
- To help ensure the integrity of financial reports.

An effective system of internal loan review incorporates both a high degree of independence (by the credit review staff) and also uses loan officers (who may be more knowledgeable but less independent) to serve as the first line of defense in identifying emerging problem loans. Because of their frequent contact with borrowers, loan officers should normally be able to identify potential problems before they are apparent to others.

While independence is ideally achieved through establishing an independent department staffed with credit analysts, cost and volume considerations may not justify such a system in smaller institutions. Nevertheless, independence can be maintained provided credit analysts do not have control over the loans they review and are not a part of, or influenced or controlled by anyone associated with, the loan approval process.

In addition to independence and the importance of lending officers being held accountable for promptly reporting their problem credits, regulators should also consider the following factors when evaluating the overall quality and adequacy of an institution's internal loan review system:

- Accuracy of internal loan classification ratings;
- Qualifications and independence of loan review personnel;
- Frequency of reviews;
- Method of loan selection;
- Scope of the review;
- Depth of the review;
- Work paper and report distribution; and
- Follow-up.

Classifications should accurately reflect the risk of nonrepayment. If an institution's classification system differs from the categories outlined in the classification of assets regulation § 563.160, it should ensure that the definitional criteria of its categories closely parallels those contained in the regulation to both promote accuracy in filing quarterly reports and enable regulators to efficiently test the accuracy of the classification ratings.

The qualifications of loan review personnel, including level of education, experience, and extent of formal credit training should all be evaluated.

Internal reviews should be conducted on a regular basis for all lending areas. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified all major problems in the portfolio and reflect the quality of the portfolio as a whole.

The review should include, in addition to a “cut” or sampling of the portfolio, large loans past due, nonaccrual, renewal, and restructured loans; loans previously classified; insider loans; and interrelated or common-interest loans.

The review should include an analysis of selected loans for credit quality, concentrations, sufficiency of credit and collateral documentation and proper lien perfection, proper approval by the loan officer and/or loan committee(s), adherence to any loan agreement covenants, compliance with internal policies and procedures and laws and regulations.

The internal review process should contain provisions whereby it maintains a list of loans reviewed, the date of the review, and credit rating summations to substantiate assigned credit classification ratings, including “pass” loans, and should be prepared on all loans reviewed that exceed an established dollar size. The results of the loan review should be submitted to the board of directors at least quarterly. In addition to reporting current findings, comparative trends should also be presented to enable the directorate to spot significant changes in the overall quality of the portfolio.

Findings should be reviewed with appropriate loan officers and department managers and regular reports should be made to the board of directors. Responses of present or planned corrective action of all deficiencies and loans with identified weakness should be required, as well as the time frames for correction.

In addition to the above, as further means of ensuring that the internal loan review function successfully achieves the outlined objectives, the internal loan review program should be in writing and be approved by the board of directors as a visible sign of management’s and the directorate’s full support of and commitment to the program.

Environmental Risk and Liability

Environmentally related hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its mortgage or commercial loans and real estate investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems, or oil and gas wells.

Thrift problems with pollution and hazardous waste contamination have grown as federal, state, and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for cleaning up the environment. Thrifts must be aware of and concerned with regulations that impose clean-up liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Thrift Bulletin 16 (TB 16), issued on February 6, 1989, discusses the following potential categories of risks that a savings association can face from making loans secured by environmentally contaminated property.

Potential Risks and Liabilities to Institutions

There are at least eight basic categories of risk that an association can face as a result of environmentally contaminated property. These include:

(1) The risk that the collateral for a real estate loan or property to be acquired may be drastically reduced in value after discovery of the existence of hazardous waste contamination.

(2) The risk that the borrower cannot repay the loan if the borrower must also pay for the cost of cleaning up the contaminated property. The cost for cleanup in many cases can be significant and may exceed the institution's encumbrance on the property.

(3) The risk that a mortgage loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up hazardous waste contamination may have priority over a lender's mortgage.

(4) The risk that a lender may be liable to the extent of any credit extended to any debtor who has operated property containing hazardous wastes, has generated such waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous waste.

(5) The risk that the thrift may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property or becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the disposal of toxic or hazardous waste.

(6) The risk that a lender may not be able to pursue its foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could lead to charging off the loan balance.

(7) The risk that the borrower does not maintain collateral or property with an environmental risk potential in an environmentally sound manner.

(8) The risk, aside from the statutory liabilities that can be imposed for toxic waste contamination, of potential liability for personal injury or property damage.

To address these potential risks and liabilities, thrifts should develop internal underwriting and risk management procedures and revise their mortgages, guarantees, indemnities, contracts, and other loan documents to protect themselves against potential environmental hazards and to maintain the value of their loans and real estate investments.

Purpose of Environmental Risk Policy

As indicated in TB 16, the most expeditious means by which a thrift institution may commence protective action against environmental risks and liabilities is to develop and implement a written environmental risk policy. Such a policy will serve several critical purposes. It will:

(1) establish a level of due diligence in all real estate transactions;

(2) establish a means of identifying excessive environmental risk in properties being considered as collateral or for acquisition, or in properties being analyzed prior to foreclosure, or to meet standards set by buyers in the secondary market;

(3) minimize environmental contamination of the borrower's property through the life of the loan by alerting institution staff to a potential problem property and providing for collateral monitoring and periodic property inspections throughout the loan term;

(4) establish guidelines for a satisfactory inquiry into the uses of property and for other protective actions as needed to qualify for the defense of "innocent landowner" in the event that it acquires, through foreclosure or otherwise, a contaminated property that it could not have reasonably known to be contaminated. Note: "innocent landowner" is a term used to denote an exception from liability for an individual or entity who acquires property unaware of the presence of hazardous material. The landowner must not have conducted, permitted, or contributed to the release of hazardous substances and must have had, after appropriate inquiry, no knowledge of the pollution at the time the property was acquired; and

(5) support the institution's adherence to the principles of safety and soundness.

Environmental Risk Policy Components

TB 16 also details 12 elements that a comprehensive environmental risk policy should address. In addition, TB 16 provides a brief description of each of the various types of environmental risk reports that savings associations may need to use.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.46	Commercial Loans

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.4	Affiliate
§ 561.13	Consumer Credit Classified as a Loss
§ 561.18	Director
§ 561.24	Immediate Family
§ 561.32	Normal Lending Territory
§ 561.35	Officer
§ 561.47	Slow Consumer Credit
§ 561.48	Slow Loans
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
§ 563.93	Loans to One Borrower
§ 563.100-101	Real Estate Lending Standards
§ 563.160	Classification of Certain Assets
§ 563.170	Examination and Audits; Appraisals; Establishment and Maintenance of Records
§ 564	Appraisals

Office of Thrift Supervision Bulletins

RB 15	Covered Asset Sales
TB 16	Environmental Risk and Liability

OTS and FHLBB Resolutions

83-241 Geographic Lending Restrictions ¶ 37,362.041

84-580 Geographic Lending Restrictions ¶ 37,362.551